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Special bulletin no. 21 (1923, December); Preferred stock; Insurance premiums; Customers' accounts; Expenses; Salt; Paper industry; Mining companies; Silk hosiery company; Newspaper costs; Treasury Department's adjustment of depreciation; Capital gain -- 2 year holding period; Valuation of copyrights

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American Institute of Accountants

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DECEMBER 1923, SPECIAL BULLETIN No. 21

[The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinions of accountants to whom the questions were referred. It is earnestly requested that members criticise freely and constructively the answers given in this or any other Bulletin of this series.]

PREFERRED STOCK

Q. The "A" corporation purchased from the "B" corporation certain plant assets and good will, agreeing to pay X dollars representing 60% of the purchase price and shares of a specially created preferred stock of the "A" company representing 40% of the purchase price. The payments of the money and shares of stock were spread over a period of about five years.

The "B" corporation upon receiving the shares of stock credit the par value against the total purchase price of the property, but immediately write the value of the stock off the books of account upon the theory that the stock has no known value. The process of reasoning by which the "B" company evolves the above theory is:

(1) There are two issues of preferred stock preceding the issue which it has received in part payment for its property.

(2) There is a bond issue preceding the above mentioned preferred stocks.

(3) The business of the "A" company has fallen off to such an extent since the purchase of the property of the "B" company was made that the "A" company has not operated the plant of the "B" company since its acquisition above 25% of its capacity.

(4) 60% of the purchase price of the plant (which is being received in cash) is greater than the sound value of the property sold by the "B" company.

(5) The preferred stock received by the "B" company has no known market value although the preceding issues of stock are listed on the N. Y. Stock Exchange and are quoted below par.

The question which we wish answered is:

Should a stockholder of the "B" company, upon receiving the shares of preferred stock of the "A" company, as a dividend of the "B" company return, in his individual tax return, any value for the said preferred stock? The said stock bears 7% interest cumulative and is callable at the option of the "A" company at 102 and accrued interest.

It must be remembered that the "B" company carried this stock at no value in its assets, and that therefore the surplus is not affected by a distribution of the stock and that at present no one knows what value, if any, the stock has.

A. According to Article 1547 of Regulations 62, dividends received by a stockholder of the "B" company in the form of preferred stock of the "A" company, are income to the recipient to the amount of the market value of such property at the time of its receipt.

It is stated in the question that the preferred stock has no known market value, but it is noted that this statement is coupled with a reference to the New York Stock Exchange. The fact that stock is not listed or quoted on a stock exchange does not carry the implication that the stock has no value, even though preceding issues of the same company are quoted below par. The various other conditions stated certainly have a bearing on the value of the preferred stock, but taken as a whole do not necessarily indicate that the stock is without value. In this connection that part of Solicitor's Law Opinion 962, which deals with the fair market value of stock received, is of interest.

If all channels have been explored and it is conclusively determined that the stock had no market value at the time of its receipt, no income will accrue to the recipient from this source until it is realized.

INSURANCE PREMIUMS

Q. A corporation takes out a considerable amount of fire, tornado and similar insurance for a period of three years. At the end of its fiscal year, it reduces the amount of the premiums paid to a short rate or cash surrender value.

Is this item a current asset, or must it be considered as a deferred charge?

A. In the case cited, we do not see that any valid objection can be taken to the inclusion of the cash surrender value of insurance premiums amongst current assets.

The practice of reducing unexpired insurance premiums to their cash surrender value and including them in the balance-sheet as current assets while in a sense conservative can hardly be recommended. It results in overcharging one period with insurance to the advantage of the following period, and to that extent destroys the value of comparisons of earnings and operating costs. Unexpired insurance is so generally looked upon as a deferred charge that its inclusion even at its cash surrender value amongst current assets might create an impression that an attempt was being made to inflate current assets.

CUSTOMERS' ACCOUNTS

Q. What is the common practice in connection with the verification of customers' accounts? Is it usual for accountants to send statements of account to all customers carried on the books of a client, asking them to confirm the correctness of their accounts, without obtaining the client's authority, or should they in all cases obtain this authority before so doing?

A. Under no circumstances should confirmations be sent out to customers without the authority of the client. Some clients are averse to making known to outsiders the fact that their accounts are being audited; others object to the practice of sending out confirmations to customers because of the expense involved. The practice, so far as we have observed, is to rather urge the client to have it done, and if not done, to make proper qualification.

EXPENSES

Special Bulletin No. 20 contains an inquiry regarding the treatment of organization expenses and other items in the case of a light and power company. The conclusions arrived at are generally correct in principle but the question cannot be answered completely without a knowledge of the state in which the operations of the public utility referred to are carried on.

The decisions of state commissions having jurisdiction over the public utility should be referred to and also considered in the light of the Galveston Electric Case in the U. S. Supreme Court, the decision having been written by Justice Brandeis.

SALT

Q. Will you kindly send me a chart of accounts relative to the production of salt.

A. The following chart of accounts is relative to the production of salt by a mining company and by a company which produces salt by the evaporation process.

These accounts do not show the classification of the operating expenses in as much detail as might be desired. The labor has not been classified to show the cost of the various operations.

Chart of Accounts for a Salt Mining Company

Sales
Allowances and discounts on sales
Cost:
- Labor
- Superintendents' salaries
- Fuel
- Powder
- Fuses
- Candles and carbide
- Electric power
- Oil, waste and packing
- Plant repairs & maintenance
- Car boards
- Feed and stable expense
- Mine office and general expense
- Bags, barrels, packages, etc.
- Transportation
- Plant depreciation
- Depletion of salt deposits
- Property taxes
- Insurance
- Repairs and maintenance of laborers' houses
- Rents received from laborers' houses
- Farm expense

Selling expense:
- Salesmens' salaries
- Salesmens' expenses
- Commission
- General sales expenses
- Salaries of officers and clerks, sales dept.
- Branch office expenses (detail by branches)
- Rent of warehouse, etc.
- Salaries and expenses, warehouse and store
- Delivery expenses, including depreciation of automobile trucks

Administrative expense:
- Salaries, administrative dept.
- Salaries, account dept.
- General expenses, administrative dept.
- General expenses, miscellaneous
- Legal expenses
- Taxes, other than federal income taxes
- Bad debts
- Interest earned
- Interest paid

Reserve for federal income taxes.

PAPER INDUSTRY

Q. We desire to set up classifications in plant asset records for the various units that should be separately valued in a paper mill. The paper machine itself, of course, consists of many different units that might receive a very detailed classification in such plant asset records.

To what extent would the members experienced in this line, advise us to sub-classify a large paper machine in a modern paper mill?

A. In our opinion, there is seldom a necessity for a more elaborate general ledger classification than suggested by the following:

Land
Buildings
Manufacturing Equipment:
- Material preparation
- Conversion
- Finishing

Steam Equipment
Maintenance Equipment
Office Furniture and Equipment.

The division of manufacturing equipment may be dispensed with in most cases.

MINING COMPANIES

Q. I wish to obtain the collective experience of the various members of the Institute on the following points:

1. What is the accounting treatment by large mining companies of compensation paid to employees under the workmen's compensation acts of the state in which they are mining, where they do not pay premiums to an insurance company to take care of losses, but assume all liability themselves? Generally, accidents resulting from mining operations are classified into two divisions by the workmen's compensation acts; non-fatal and fatal. In the former group are accidents which incapacitate a workman temporarily and those where a workman suffers the loss of a member of the body such as an eye, arm, finger, etc., without resulting in death, while the latter includes deaths occurring at the time of the accident or as an immediate result of the accident. Under the state act I have in mind the workmen's compensation must be paid, subject to certain rules and regulations, as follows:

> Temporary incapacity: a certain percentage of weekly wages to be paid during the incapacity of the workman, not to exceed a certain amount per week or a certain number of weeks.
>
> Loss of member of the body (called a specified injury): a certain amount is fixed by the state for each member. This amount must be paid in full, in weekly installments, regardless of the liability of the man to work within the time weekly installments are paid.
>
> Death: a fixed amount to be paid in weekly installments to heirs.

Under the law compensation payments take rank immediately after preferred claims for taxes and wages and in the case of the bankruptcy of the company would be paid in full prior to payments to general creditors. The state may require the company to make periodical deposits with it out of which all claims arising under the act may be paid by the state.

2. Payments for taxes on land owned adjacent to mines but not used for mining purposes, which might include land upon which company houses are built and rented to employees.

3. Payments for maintenance expenses of inactive branches of the mine.

4. Various federal revenue acts permitted mining companies to charge against the income reported to the federal government depletion based on the fair value of their mineral deposits at March 1, 1913. In many cases this value was in excess of the original cost of the mine lands. How was the excess value treated on the company's books and was the whole depletion allowed by the government charged as an operating cost on the company's books? Also how was the new value at March 1, 1913, treated on the company's balance sheet?

With regard to the first and last questions I would appreciate it if illustrative entries could be submitted showing the various accounts affected. With regard to the second and third questions, are such payments considered as direct operating costs or charged to a miscellaneous account which is deducted after net profit from operations is ascertained?

A. It is our practice where mine operators are self-insurers to set up as a liability the compensation due for injuries or fatalities, charging operating expenses with same. "Cost of mining to compensation insurance reserve."

We invariably recommend, and insist as far as we can, that an insurance fund be opened and as awards are made that the amount of liability be taken out the business and paid into this fund. Then that all compensation claims be paid out of it, the same being debited to "compensation insurance reserve."

Taxes on land not used for mining purposes would be charged to taxes and not operating expenses. Taxes on land on which company houses are built should be charged against "house revenue."

Such a condition has not come to our notice. In our opinion, however, such payments should be set up separately on profit & loss account. If you refer to old workings being used to bring out minerals or for ventilation, then such expense should be charged to operating cost.

It is our practice to increase the value of the mineral deposit and set up a special reserve in respect of same, "reserve for re-valuation of mineral deposits," (i. e., substituting ore deposits, coal lands, or whatnot) and so show on the balance-sheet.

It is not our practice to treat depletion as an operating cost; but to set it up monthly as a charge to profit and loss. Profit and loss to depletion reserve."

The "reserve for re-valuation of mineral deposits" will eventually become surplus, supposing that mining will be continuous to exhaustion, and it would be correct accounting to carry from the reserve account to a "surplus from depletion on appreciation," a sum equal to the same proportion of the depletion that the appreciation bears to the total re-valuation.

We have found in our files the following data:

1. **Workmen's Compensation:**

Only one of our clients, so far as we can find, has not recently carried workmen's compensation insurance and this one has, during the past year, taken out such a policy, so that its present practice will not throw any light on the question asked by your correspondent.

Prior to taking out the policy, all payments on account of workmen's claims were charged directly either from cash disbursements or voucher record to a claims and accidents account which was a part of mine expense.

Another client which does not now carry compensation insurance sets up a reserve each month on the basis of premiums formerly paid when such insurance was carried.

2. **Taxes on Land Not Used for Mining Purposes:**

We can find no case which exactly meets the conditions stated by your correspondent. In our opinion, however, the tax should be apportioned between the land which yields an income and that which does not, the former, of course, being a deduction from the income received, while the latter would be included in the carrying charges of non-operative property.

3. **Payments for Maintenance of Inactive Branches:**

In the only case which has come under our observation, these were charged off as expense to be deducted as net profit from operations after ascertained. In this treatment we fully concur.

4. **Depreciation on Appraised Value and Excess of Cost:**

We find no case of this kind, but we have a parallel one of depreciation on appraised value of assets in excess of their cost. The amount of appreciation was carried to a surplus arising from appreciation. The periodical credit to reserve for depreciation is apportioned between cost and appreciation by an entry similar to the following:

Debit surplus arising from appreciation	$1,000.00
Debit depreciation (operating expense)	8,000.00
Credit reserve for depreciation	$9,000.00

SILK HOSIERY COMPANY

Q. A silk hosiery company operates its plant on the basis of three shifts covering in all twenty-four hours.

The officers of the company are desirous of writing off depreciation to cover the unusual wear and tear on the machinery.

Will you kindly furnish me with the standard rates of depreciation on machinery used in the manufacture of silk hosiery and also if possible your recommendations as to what addition to the percentages should be made to cover the unusual circumstances before mentioned?

A. Our observation is that depreciation on silk working machinery is somewhere between 5% and 10% per annum; nearer 5% than 10%, however. We have in mind one case where the company has agreed with the treasury department on the rate of 6⅔%, based on a 15 year life, to cover all kinds of silk working machinery for fabricating and knitting. We are informed, however, that for machinery used in the manufacture of silk hosiery, taken by itself, this rate is fairly liberal and that a twenty year life is a fair basis if used in making fashioned hosiery; though if the machinery is known as "circular" a life of 12 to 15 years would be nearer the mark.

As to the effect of operating the plant on a 24 hour per day basis this obviously increases the wear and tear greatly and the depreciation rates should be increased. But as there is an element of obsolescence in the adoption of depreciation rates we do not think the rates should be increased in full direct proportion with the increase in the working time. The company's management will have to use their own judgment as to the effect of increasing the working shifts but our guess would be that the depreciation rates for a 24 hour day should be raised by from 50 to 100% over those for a normal working day of 8 or 10 hours.

NEWSPAPER COSTS

Q. I am desirous of obtaining information regarding comparative costs in connection with a large city newspaper. What should be the general cost of each department?

A. The only information we have at hand is in connection with a newspaper in a city of a population of approximately 700,000, which has a morning, evening, and Sunday edition.

The following are certain statistics regarding the operation of this paper for two consecutive recent years:

	Later Year		Prior Year	
	Ratio to Total	Ratio to Gross Earnings	Ratio to Total	Ratio to Gross Earnings
Gross Earnings:				
Subscriptions and paper sales		22.17%		22.31%
Advertising		77.83		77.69
		100.00%		100.00%
Operating Expenses:				
Newsgathering and editorial	22.36%	17.70%	18.81%	16.03%
Composition and printing	56.60	44.79	61.81	52.69
Circulation	9.14	7.23	8.51	7.26
Maintenance of property and plant	.76	.61	.60	.51
General expense	11.14	8.81	10.27	8.75
	100.00%	79.14%	100.00%	85.24%
Profit from operations		20.86%		14.76%

TREASURY DEPARTMENT'S ADJUSTMENT OF DEPRECIATION

Q. We are interested in ascertaining the practice of members of the Institute in regard to the placing, upon the books of clients, entries adjusting values due to disallowance of depreciation or in some cases additional allowance for depreciation.

The point is, that settlements are made in the matter of federal income taxes for say, 1917 and 1918, in which adjustments for depreciation have a part. Are entries made on the books at once upon the receipt of such settlement or are members of the Institute withholding the making of such entries until they have received notification of the government's audit of more of the subsequent years?

Our belief is, that if one were to wait until the government "caught up" in the checking of the current year, several years might elapse and in the meantime, adjustments might be forgotten, so that the books would not show the proper results of settlements already made.

A. It does not follow that because the treasury department adjusts depreciation for income tax purposes, the taxpayer is bound to follow them in the rates and calculations adopted for book purposes. There are cases where the taxpayer adheres to his own rates and must, therefore, maintain a running difference between the depreciation calculations for book purposes and those for income tax purposes.

But assuming, as your inquirer seems to assume, that the treasury's rates are acceptable to the taxpayer, we always advise that once the rates and basis have been agreed upon, the taxpayer should make his adjustments at once for the years covered by the settlement and should also adjust subsequent years, though not yet reviewed by the department to the revised basis adopted as that of the taxpayer even though initiated by the treasury department.

CAPITAL GAIN—2 YEAR HOLDING PERIOD

Q. When does the two year period, which is a qualification of "capital gains", begin to run for the beneficiary of an estate or trust in the case of property received as a distribution of corpus or of stock dividends.

A. So far as we know, no regulation or ruling has been issued on that specific question. Our opinion is, however, that in case of distributions, both of corpus and stock dividend shares, the distributee (the beneficiary) should calculate his two year period from the date of the decedent's death. In other words, we regard the beneficiary as acquiring, as of the date of death, a vested right to, and beneficial interest in, any property subsequently distributable to him, and consider that the incidence of an estate or trust, while it may defer the time when such property is reduced to possession by the beneficiary, does not in the meanwhile transfer such right or interest to itself and, therefore, cannot alter the distributee's right to regard himself as the beneficial owner of such property from the date of decease.

Our opinion is based on conclusions we have drawn from several treasury rulings:

I. T. 1759 provides that whether or not the executor or testamentary trustee is the same person, the two year period begins to run from the date of the decedent's death. In other words, the incident of control by an estate before the property passes to a trustee does not thereby destroy the trustee's right to compute the two year period, if he sells the property, from the date of death. By analogy this would also seem to be true if a beneficiary stood in the trustee's shoes, or both an estate and a trust intervened between the date of death and ultimate possession by the beneficiary.

Again, I. T. 1660 provides that if property constitutes the subject matter of a specific legacy, it is acquired as of the date of death.

Furthermore, O. D. 667 rules that an estate cannot derive a taxable gain from the transfer of property to a legatee, and that the basis for determining gain or loss on a sale of the property received by the legatee is the value of such property at the date of the testator's death whether the devise or bequest be specific or residuary. We believe that since a capital gain is computed in precisely the same manner as any other taxable gain, obviously it cannot be maintained that the taxable gain for a benficiary is based on the value of the property at date of death, and, on the other hand, that if such gain is a capital gain it is based on some other value as of a different date.

In the case of the stock dividend, I. T. 1765 provides that the two year period starts from the date of the acquisition of the stock upon which the stock dividend is declared. In other words, if the original shares formed part of the corpus of the estate or trust, the two year period on the dividend shares would also commence upon the date of decease.

VALUATION OF COPYRIGHTS

Q. What is the mathematical basis for valuing copyrights of a going book-publishing concern? This is in connection with the sale of a business.

A. The primary element to be considered in valuing a copyright is its probable future earning power. The mathematical determination of the value of future earnings based on an average of past earnings (commonly used in the case of other intangibles as patents and good-will) cannot ordinarily be recommended in the case of copyrights. Earnings from copyrights are too erratic and subject to fluctuation. Past results do not ordinarily reflect on accurate measure of future earnings. A "best seller" in fiction may produce large earnings during the first three years of its life; in subsequent years its returns may be negligible. On the other hand, a standard text book may, through proper management and publicity, be made to produce an increasing amount of income each succeeding year of the life of the copyright. It is clear that a true value of the copyrights of a book publishing company may be arrived at only by a careful appraisal of the probable earnings of each individual copyright after taking into consideration the peculiar conditions attaching to each.

Once the estimated future earnings are agreed upon, a mathematical basis may be used to determine the fair value of the copyrights through application of the "present worth" formula to each years earnings:

$$P = A + (1 + i)^n$$

In which P = present worth
A = amount to be received
i = agreed interest rate
n = number of years